IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF DELAWARE

In re:	:	
	:	
Genesis Health Ventures, Inc., *et al.*,	:	Civ. Act. No. 05-CV-427 (KAJ)
	:	Related to Case No. 00-2692 (JHW)
Debtors,	:	Jointly Administered
	:	
Richard Haskell, *et al.*,	:	
	:	
Plaintiffs-Appellants,	:	
	:	
v.	:	Adv. Pro. No.: 04-53375 (JHW)
	:	
Goldman, Sachs & Co., et al.,	:	VOLUME II OF V
	:	
Defendants-Appellees.	:	

DEFENDANTS-APPELLEES' APPENDIX IN SUPPORT OF THEIR BRIEF IN OPPOSITION TO THE APPEAL OF RICHARD HASKELL ET AL. FROM THE MAY 10, 2005 ORDER OF THE BANKRUPTCY COURT

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UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEW JERSEY

IN RE:	. Case No. 00-2692, 00-2494
GENESIS HEALTH VENTURES AND MULTICARE AMC, INC.,	. 15 North 7th Street . Camden, New Jersey 08102
Debtor,	. August 29, 2001 . 9:05 A.M.

TRANSCRIPT OF HEARING ON MULTIPLE MOTIONS
BEFORE HONORABLE JUDITH H. WIZMUR
UNITED STATES BANKRUPTCY COURT JUDGE

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(Call to the order of the Court at 9:05 a.m.)

THE COURT: Please be seated. Good morning.

MR. WALSH: Good morning, Your Honor.

THE COURT: Good morning.

MR. WALSH: It seems like just yesterday when we were together.

THE COURT: Indeed.

MR. WALSH: Your Honor, just one technical item. We had filed our draft, or our confirmation order, and we have copies available for people in the court if they'd like to take a look at it. So, just let one of my colleagues know.

We have completed our witness testimony for the debtor. We understand that there are two other witnesses by supporting -- by parties supporting the plan, and we propose to go forward with them before we hear from the witnesses opposing the plan --

THE COURT: I --

MR. WALSH: Is that okay?

THE COURT: Yeah.

MR. WALSH: Before I do that, may I hand up our proposed order?

THE COURT: Certainly.

MR. WALSH: Thank you.

THE COURT: Thank you.

(Brief pause)

MR. ZELMANOVITZ: Good morning, Your Honor.

THE COURT: Good morning.

MR. ZELMANOVITZ: Menachem Zelmanovitz of Morgan, Lewis and Bockius, on behalf of Mellon Bank, as the agent for the senior lenders. Your Honor, I'd like to call to the stand Mr. David Schulte.

(Brief pause)

THE CLERK: Place your left hand on the Bible, raise your right hand.

D A V I D S C H U L T E, WITNESS, SWORN

THE CLERK: Please state your name for the record, spelling your last name.

THE WITNESS: Fine. My name is David Schulte, S-C-H-U-L-T-E.

(Brief pause)

THE WITNESS: Good morning, Your Honor.

THE COURT: Good morning.

DIRECT EXAMINATION

BY MR. ZELMANOVITZ:

Q Mr. Schulte, by whom are you currently employed?

A I'm employed by Chilmark Partners --

Q And what is --

A -- spelled C-H-I-L-M-A-R-K.

Q And what is Chilmark Partners.

A Chilmark Partners is an investment banking firm based in

Chicago. Our principal work is in financial organizations and in solvencies.

Q And what is your position at Chilmark?

A I'm its managing partner.

Q Does Chilmark have an engagement in connection with the Genesis and Multicare bankruptcy cases?

A Yes sir.

Q And what is that engagement?

A We are employed by Morgan Lewis as counsel to the agent for the senior secured lenders, both of Genesis and Multicare.

Q And when did that engagement begin?

A Approximately one year ago.

Q Mr. Schulte, would you briefly describe for the Court your educational background?

A Yes. I have a Bachelor's degree in Economics from Williams College. I studied for a year at Oxford University, and I have a law degree from Yale.

Q And at Yale, did you earn any special distinction?

A Yes. I was Editor-in-Chief of the Law Journal.

Q Would you briefly describe for the Court your employment history following your graduation from law school?

A Yes. I was a law clerk for one year for Mr. Justice Stewart (phonetic) on the U.S. Supreme Court, and I then went to work for Northwest Industries, which was a diversified manufacturing company in Chicago. I worked there for seven

years, and then went to Solomon Brothers in 1980 to start their effort in corporate reorganizations. I was at Solomon Brothers for four years, and then I started Chilmark Partners in 1984.
Q Is it fair to say, then, that since your employment at Solomon Brothers in 1980, you've been involved in reorganizations and insolvency work?
A Yes, almost exclusively.
Q What are your responsibilities as a managing member of Chilmark Partners?
A I'm responsible for all of the work of the firm. I'm the senior person on each of the assignments that we do and each of the investments that we make, and I have administrative responsibilities, as well.
Q Had you been engaged before to act as an expert witness in connection with other matters?
A Yes, I have.
Q And have you been qualified by other courts to provide expert testimony?
A Yes, I have.
Q Would you please tell the Court the other cases in which you have been qualified as an expert?
A Yes. The first time in Bankruptcy Court, I was part of the Wicks case in California a million years ago. Subsequently, the Global Marine bankruptcy case in Houston, the Revco bankruptcy case in Akron, Ohio, last year, the Bruno case

here in Delaware, and then in the non-bankruptcy context for Resorts International before the New Jersey Casino Commission some years ago.

Q In each of those cases, did your testimony deal with the issue of valuation in connection with restructurings or insolvencies?

A Yes sir.

Q At this time, I would ask the Court to qualify Mr. Schulte as an expert.

THE COURT: Sir?

MR. KINZEY: May I ask one question on voir dire?

THE COURT: Certainly.

MR. KINZEY: John Kinzey, Your Honor, for the record. I'm representing GMS.

MR. KINZEY: Good morning, Mr. Schulte.

THE WITNESS: Good morning, sir.

MR. KINZEY: One quick question. Prior to this case, do you recall having any experience in insolvency cases involving healthcare companies?

THE WITNESS: I have not had such experience.

MR. KINZEY: I have no objections to qualifying the witness, Your Honor.

THE COURT: All right. He may be so qualified.

MR. ZELMANOVITZ: Thank you, Your Honor.

(Brief pause)

BY MR. ZELMANOVITZ:

Q Now, Mr. Schulte, in the course of Chilmark's engagement in these cases, did Chilmark perform work relating to ascertaining the value of the debtors?

A Yes sir.

Q And prior to the Chilmark report, which we will get to in a brief moment, could you describe to the Court the valuation work that Chilmark performed?

A Yes. Well, over the past year, we had been advising the secured lenders of Genesis and Multicare on all of the aspects of the plan reorganization and the negotiation of that plan. Importantly, our work has dealt with capital structure planning, and as part of capital structure planning, one brushes up against the valuation question all the time, importantly, because it was clear from the start in these cases that the senior secured lenders could not be paid back in the form that they originally held, namely, in debt securities, and that a significant fraction of their recovery had to be equity securities. So, we were circling around the issue of valuation repeatedly in the last twelve months.

Q And in connection with that work, did Chilmark work closely with another firm?

A Yes. We -- the accounting side of the professional team for the bank lenders was the Apollocano and Manzo firm. They're an accounting firm that specializes in reorganizations,

and we work closely with them.

Q What was the focus of the Apollocano and Manzo firm's work?

A It was their job to scrub the numbers on a myriad of topics, explaining to the lending group the company's financial statistics, doing due diligence for the lenders, and in connection with all the matters that came up during the year.

Q Now, did there come a time when Chilmark was asked to conduct a valuation analysis in these cases?

A Yes sir.

Q And to prepare a report as to its conclusions?

A Yes sir.

Q And when were you asked to do that?

A Oh, the request came late spring or early summer of this year.

Q And who made that request?

A Morgan Lewis.

Q And did Chilmark, in fact, conduct such a valuation analysis and prepare a report as to its conclusion?

A Yes, we have.

(Brief pause)

MR. ZELMANOVITZ: Your Honor, may I approach the witness?

THE COURT: Please.

BY MR. ZELMANOVITZ:

Q Mr. Schulte, I have placed before you what I have marked as Mellon Exhibit one.
A Yes sir.
Q Can you identify that document for us?
A Yes. This is the report that -- that our firm prepared that we've just discussed.
Q And who prepared this -- who prepared the report?
A I did, along with two of my colleagues.
Q And who are your colleagues who assisted you in preparing the report?
A John Heckle (phonetic) and Kyle Hood (phonetic).
Q Now, would you generally describe for the Court the steps you and your firm took in preparing this report?
A Yes. As a piece of background, the business of securities valuation is an interesting one, and when applied to a company like Genesis, it's particularly interesting. If we knew the future, securities valuation would be a piece of arithmetic. It would -- you know, my eleven year old could do it. What makes it interesting, what makes it difficult is we don't know the future. We know the past, given good accounting, and we glimpse at the future, and yet, all an investor or any valuer can have is the future. That's the inherent tension in the process.

We started by, and we had this over the course of a year, it wasn't just for this report, but we developed an

understanding and a sense of the dynamics in this industry, and in a way, that's a debate between Pollyanna and Cassandra. Pollyanna says, this is a vital service performed to give care to elderly people who need it, and as a fraction of the American population, elderly people are a growing fraction, and therefore, demand is in the bag. And for any business where demand is assured going forward, the financial future is, at least from that perspective, bright.

Cassandra replies, yes, but the demand for the service is, first of all, grudging. There's not a person, I would say, in this courtroom who has an elderly relative who has ever said, yippee, I'm going to a nursing home. This is people come to nursing homes when they don't have an alternative. They don't want to go, their families don't want to send them, and as it turns out, socially, nobody wants to pay for it.

And so, we have an iron -- and it's also very expensive. A private pay patient at Genesis pays $200 a day. There are not many elderly people who with alacrity would check into a hotel for $200 a day forever, for the rest of their lives. And most people who go into these nursing homes don't come out alive unless their benefits run out and they have no choice.

So, this is a -- it's a melancholy business. This is a business of need and from a financial perspective, leaving

aside the human dynamic, when people have testified before and I heard the testimony yesterday about the payor mix, what that means is it's expensive and people can't pay for it themselves. And it becomes, then, a business where the revenue stream is a function, not only of the demand which is assured, but of the person who is writing the check, and that's a function of politics, and that's a function of budgetary politics.

And what we've seen in the last ten years in this business, good times and bad, owing to decisions made by politicians who are responsive to things in addition to the needs of the population. I say that as background because it's -- to get giddy about this business is, I think, to ignore the context of the industry.

Now, that said, when we look -- when we do valuation, we look at valuation work, recognizing the inherent impossibility of knowing the future. We look at everything we can. And there are a number of ways that one does this. There were four that we attempted here, as has been testified by one of the other people yesterday. The approach that looks at historical transactions proved irrelevant because when the payment rate structure changed a few years ago, there haven't been any subsequent reported transactions that we could find, so we ignore that one.

But then, we looked at the valuation of comparable companies and we looked at discounted cash flow, and we did

something else which we can come to whenever you'd like, which was to look at the market value of the company today, because even though it's a Chapter 11 debtor, there is a market for its securities today, and they're trading at a price, and we looked at all of those things.
Q Mr. Schulte, let's turn to the first evaluation method that you mentioned and focus on that for the long term care business, and that would be the comparable company analysis.
A Yes. Your Honor, I'm looking behind Tab B of this report, it's page -- denominated page four. Yes sir.
Q Now, would you explain to the Court the steps you followed in performing this analysis?
A Yes. Again, a word about context because there's been a lot of testimony about the comparable company method. The idea here is very simple. Doing it is less simple, but the idea is simple. It says, if there is a public marketplace which most people who are knowledgeable in this area regard as relatively efficient and able to digest information from disparate source and produce valuations, and if there are, in fact, companies in that universe who are comparable, meaning similar, to its reasoning by analogy, who are like the company in question, then if one analyzes the valuation of those entities, it may shed some light on the valuation that -- of the company in question.
We did that. We amassed sort of a dizzying array of

statistics on Genesis and Multicare. We had access to the company and its public information, its non-public information, the Apollocano and Manzo reports, and we have laid all that out, Your Honor, behind Tab G in Sections one and two, and all kinds of statistical information. And then, we put together comparable data on as many public nursing home companies as we could find, and we found six.

Q Now, let me ask you on that point, you've heard testimony from other experts with respect to the long term care business where they utilized three comparable --

A Yes.

Q -- companies. In your report, you use six.

A Yeah.

Q Could you tell us why you chose to use more companies?

A Well, in principle, doing this work, the more data points there are, the greater one's confidence that some statistical fit is valid. So, anyone, I think, doing this would be pulled into the direction of looking at as many comparable companies as one could find.

Q Now, by using six rather than the three, did that affect, in an way, the information you utilized in preparing your analysis?

A Well, it turns out that three of the six are not companies where there are readily available estimates of future profit. Forthen (phonetic) Corp., sorry, Kindred, and for Beverly and

Manor Care, those are widely followed companies, and there are more or less consensus estimates of the future. For the other three, which are somewhat smaller, the data are a little harder to come by, and in fact, one of them is part of another company, and we had to do an analysis that de-consolidated it to get the U.S. Nursing Home business out. And there was just less available in the way of forward information.

So, in order to preserve the universe, we chose to use trailing 12 month information, i.e., actual information through June 30, which analytically is a little impure because one can only own the future, can't own the past. Yet, it's better in the sense that we don't get involved in endless bickering about what the future is, so long as the accounting is good, the, you know, the corpus of data for the companies is publically reported, analyzed, certified actual data.

Q So, to be clear, does the use of, for the last 12 months, historical numbers as opposed to projected numbers, prejudice the analysis in any way?

A No, I think not. I think what's important is to, then, reapply whatever multipliers, and there's been lots of testimony about multiples. If one applies the multiples against the correct body of data, i.e., there's no arbitrage of time periods. If you took a multiple of past earnings and applied it to future earnings, that would be incorrect. That's making a non-analogous comparison.

But to create a multiple on a common body of data for historical earnings and apply it to that same period as historical earnings is accurate unless some particular company in the universe has prospects different from its peer group, something special is happening, whereas other, you know, there's otherwise something unique to the company.

But in this case, and we thought about this a lot. In this case, the main event was changing the economic lives to this company or these companies are the new reimbursement rates under Medicare. They arrived in April of this year for all of the universe, and they're in place for all of the universe, at least through late 2002. They affect everyone, more or less, the same way.

And so, we thought there would be no particular prejudice in using the trailing 12 month data correctly applied.

Q Now, we've heard some testimony yesterday, but I do note that in performing this analysis, you used a term, EBITDAR, and would you explain to the Court how that term differs from EBITDA?

A Yes. I'll explain why.

Q And just one moment, Mr. Schulte, if you can refer specifically to page 5A of your report. That may be helpful.

A The idea, Your Honor, in doing this, and in making these refinements is, again, the search for comparability. In

principle, the idea of valuation through comparables is to see what the market capitalization of Company A is, vis-a-vis, its profits, and apply that, if it's comparable, to Company B. I mean, that's the soul of the exercise.

It turns out that, and this is not -- this is true not just in nursing home companies, it's true in hotels and retail stores, but businesses that regularly incorporate real estate as part of what they do, it turns out they finance the real estate in different ways. And for people who finance the real estate through leases rather than through ownership and mortgage finance, for example, the numbers get different because for that first group, thanks to the accounting profession's definition of what can be expensed and capitalized, the cost of the capital is rent which is shown on the income statement. One way it's not interest which would be for a mortgage, so what this is about is putting people on equal footing, independently of how they've chosen to finance their real estate.

So, on Page 5A is a simple numbers exercise. At the top of the page, we have Genesis, this is the long term care portion of Genesis only. We have their EBITDA, and we add to it their rental expense, arriving at the EBITDAR which is -- so, the R is simply before rent, and we then, apply multiples which we can get to, which we derive from the comps, and to get you to, if you will, an adjusted enterprise value from which

you, then, have to deduct the capitalized value of the leases to get to a comparable enterprise value. That's just the steps to the exercise --

Q So, in that sense, that is to be able to compare companies in the long term care business which own its real estate to companies in the same business which lease their real estate.

A Exactly so.

Q Now, turning back to your analysis, would you tell us how you determined the valuation multiple for each of the comparable companies?

A Yes. Well, we -- we arrayed the data in the way that I just described, and in this report, there's a summary of that in the statistical part on the back. It's there in brutal detail. But on Page 7A, which is again behind Tab B, Your Honor, we lay out, reading from left to right in the columns, the three publicly available comps that you've heard described in testimony yesterday, and the three somewhat smaller -- well, you see from the revenue sizes that not -- not trivial companies, that are also in the nursing home business.

Then, in the middle of the page, we took -- we actually found two comparable companies, not just one, for Institutional Pharmacy, Omnicare and NCS HealthCare, and then toward the right of the page we have for Genesis, its long term care business, its institutional pharmacy business, and we have a separate column for Multicare, and a final column for the pro

forma combined company.

And you can see, we have revenues. All of this is done on a trailing 12 month basis through June of 2001, which is the most recent fiscal period for which public data are available. Revenues, EBITDAR, rent, EBITDA and the like, and then the enterprise value for each company, as others have testified to, is the value of its equity which is derived from the share price and the number of shares, plus the value of its debt, and added back to it, you'll see the capitalized value of his rent, which gives you the lease adjusted enterprise value, which we found actually takes some of the kinks and variability out of the valuation when you go to a EBITDAR approach.

And then, at the bottom is an important set of reference points. We have what look to be the main profitability discriminators. We have the EBITDAR margin, which is simply the pre-tax cash flow before rent divided by the adjusted capa -- divided by revenues, excuse me. Then, we have the adjusted after tax return on capital, which is done in the same way that I just described. I can go back to it if you need to. And then, we have the payor mix which you've had a lot of testimony about, because Medicaid reimbursements are at a substantially lower rate than the other payment streams into the nursing home, and that turns out to explain some things about the premier companies and the less valued companies.

Q How do you then determine what multiple to assign to the

debtor's long term care business?

A Well, it's an analytic process in which we looked at everything and tried to really read the mind of the market. Let's start at the second row on the page, lease adjusted enterprise valued at EBITDAR. And when you look at this, you'll see that once you've taken out the variability owing to the different way in which companies finance their real estate, but for Manor Care, which is much higher, you'll see that the other -- the multipliers for the all the other five -- they have five other companies, are between six and 8.4. Manor Care is 11.4 which is conspicuously higher. The question is where does one place Genesis within that. It isn't good enough to do it with a Ouija Board or by picking jelly beans out of a jar. This is supposed to be a search for real financial comparability.

We look at EBITDAR margin, for example, the first -- it's in the middle of the page, and it's the first discriminator time tied to profitability. Multicare, for the trailing 12 months, had a margin of 9.6 percent, and Genesis, 9.9 percent. If one looks at the comparable universe, that's lower than any of the six but for Extended Care which we have at nine and a half percent, but it's right -- it's near the bottom of the pile. That's a clue about where within a range Genesis would belong on a comparable basis.

Similarly, looking at the adjusted after tax return

on capital, no company in the industry is very good here, but Genesis at 3.9 percent and Multicare at 3.2 percent are very bad. They are, again, at the bottom of the pile, but for Extended Care at 3.1 percent. Those are arguments for putting Genesis toward the low end of the valuation range rather than the high end, because this is about relative profitability and about relative valuation.

Looking then at payor mix, the shorthand for this -- Medicare is a tough one because Medicare rates vary a lot with the acuity and the amount of medical care built into the service, but looking at Medicaid as the least profitable source of revenue for a nursing home company, the Medicaid fraction of revenues for Manor Care is absolutely at the low point, 33 percent. You'll see that most of the other companies are in the 40's to 50's. Beverly is a bit on the outside at almost 62 percent of the revenue mix, and then coming over to Genesis and Multicare, 49.8 percent for Genesis, 44 and a half percent for Multicare, which I would say puts them sort of in the pack and certainly does not give them any claim to the multiple of Manor Care.

The occupancy statistics for most of the companies is fairly similar, it's in the high 80's, low 90 percents. Our conclusion, looking at all of this, is that if one were situating Genesis and Multicare in the universe of nursing home companies, they would be somewhere in the middle of the pack,

middle to low end of the pack on relative profitability.

We took the range, we gave you a range of values that we deduced from this exercise, and for the range we described all of the non Manor Care companies. A low point of six, this is EBITDAR multiple, and a high point of 8.4, which on the page three summary is where we arrive at the valuation for the long term care business of Genesis and for the long term care business -- and for the business of Multicare. That is for Genesis a low end value of 407 million, long term care business only, a high end value of 624 million, and for Multicare, a low end number of 269 million and a high end of 416 million.

And that's not the end of the inquiry for Genesis because there is fully half the business, a bit more than half the business is pharmacy. That makes Genesis quite a unique company because there's no peer that we could find that has anything like that intense contribution for pharmacy, and the pharmacy business is a better business than the long term care business.

In the middle of the page, we have two columns for Institutional Pharmacy. Omnicare, which is the market leader, has an enterprise valued EBITDA multiple of 11.7. This is, again, all trailing 12 months for June 30, and NCS HealthCare, 6.8. The -- on the profitability ratios, the EBITDAR margin for Omnicare is 12 percent, and its after tax return on capital is 17.4 percent. That's -- that's an A -- that's an A grade in

American enterprise. I mean, that's a for real company with a real rate of return on capital. NCS HealthCare is a much weaker competitor. Its return on capital is 5.4 percent; it sort of looks like a nursing home.

When you come over to Genesis business, which is the second column under the heading, Your Honor, Genesis, the adjusted return on capital for Genesis pharmacy business is 13.8 percent which is very respectable. It's not as good as Omnicare, and the profit margin on sales, 7 and a half percent, is not as good as Omnicare's 12, but it's pretty good. And we then, in looking at the range of values, this is -- the comparability approach for Institutional Pharmacy is frustrating because there are only two data points of independent, public companies, and one is a better company than ours and one is a worse company than ours.

This is a little bit more subjective than I like in doing this, but the thing that tipped the scales, we arrived at a multiple higher -- closer to Omnicare's than NCS HealthCare's. As we did this, in fact, we used a multiple for the pharmacy business, a range of 9.0 to 9.5 times trailing 12 months EBITDA. What kept us down was, first of all, it's not as good a company as Omnicare on profitability.

But also, the loss of the Mariner bids or at least the decline in profitability for the Mariner business, which you heard testimony about yesterday, is -- what that's about is

that Genesis is presently enjoying reimbursement rates from that customer per contract higher than the Medicaid rates and higher than anybody's new contracts. And just for sure, they're either going to lose the business or lose some of that revenue.

That business is 15 percent of the cash flow of Genesis' pharmacy business. Couldn't ignore that in taking into account in valuation. It's a wild card. It's part of the basis of this APS potential acquisition, which I'm sure we'll get into later. So, in any event, our conclusion was to use a multiple range for the pharmacy business higher than NCS HealthCare but lower than Omnicare. We chose 9 to 9 and a half times trailing 12 month EBITDA which gives us the result on page three of the range of 762 million at the low end and 804 million at the high end for the pharmacy business of Genesis.

And then you can see that we've totaled the two portions of the business to come up with a value range for Genesis of 1.1 billion on the low end, 1.4 billion on the high end, the mid point of which is $1.3 billion, which is our most likely answer.

Q That's Genesis alone?

A Yes.

Q And for the combined Genesis and Multicare?

A Again, doing the totals for the combined Genesis and Multicare, we get a low end value of a billion four and a high

end value of a billion eight, the mid point of which is a billion six.

Q Now, you did not use -- well, let's back up a moment. Could you explain to us what a run rate or a normalized EBITDA or EBITDAR is?

A Sure. This is highly relevant to any forward valuation of a company. We looked at it a lot in trying to map out a proper capitalization for the debtors because what that is -- what that asks is the question, how are they doing now. You know, not how did they do, not how does their budget say they're going to do, but how are they doing. It's a pretty good question.

And so to do a run rate, it's really sort of an extrapolation from the most recent month or quarter, taking into account what's known that may not have been fully analyzed in historic numbers, and taking into account what's known that may yet be coming that obviously hasn't been captured in historical numbers. That's what a run rate is.

Q Now, did you use a run rate or a normalized EBITDAR for the debtors in your valuation?

A In -- we didn't -- well, no, not specifically. We didn't in the comparable company information because to do it would have been mixing time periods. We found the most satisfactory data looking at trailing 12 month statistics. It's highly relevant, and if one had run rate, you know, data that you were

confident in for all of the comparable companies, that would surely be a better approach, but nobody's got that. We surely couldn't come up with that. I dare say, no one else has either. So, we were more attracted to a better universe of data, and therefore, did the historicals.

Once you derive a multiple looking backward in a trailing 12 months earnings, you must apply it to earnings from the period from which you derive the multiple. Otherwise, you're mixing time periods and, for example, if earnings are rising, you're going to get the wrong answer because you're applying too low a multiple. If earnings are falling, then you get the wrong answer because you're applying too high a multiple. So, it's terribly important to be consistent as to time period.

Q By the way, could you tell us where you obtained the information which respect to the debtor's trailing 12 months EBITDA or EBITDAR?

A Yes, from the debtor's public and non-public information, from the work of Apollocano and Manzo. We were in monthly meetings with the debtor and receiving presentations all through the last year.

Q Okay. Now, let's turn to the second of your methodologies, which is the discounted cash flow analysis.

A Yes sir.

Q I believe it begins on page 8 of your report.

A Yes, it's Tab C, Your Honor.
Q Would you explain to the Court what is entailed in preparing or performing the discounted cash flow or DCF analysis?
A Okay. In a perfect world, this is the only true faith. In a perfect world, the value of any capital asset, including a corporation, including a business, is today's present value of the cash flows that will be earned in the future. That's what any capital asset is worth. The -- and the technique that -- the arithmetic that one would use is to discount the future cash flows back to the present at a discount rate, and that would be perfection. I mean, that is truly, in principle, the best way to evaluate any security, any business, any capital asset that produces profit. It would be a bad way to do certain other things; minerals in the ground you'd do perhaps differently. Okay.

The problem is the future, and the analysis is only as good as one's estimate of the future and as only as good as one's ability to create appropriate discount rate. That's hard for any business. Rate war and buffet line is all estimates are difficult, particularly those involving the future.

In this industry, given the massive changes in adequacy or inadequacy of the payment stream, the payment mix, I don't think anyone's forecast are worth a damn. And kind of -- not the companies, with greatest respect to the company, we

are in a Chapter 11 case. And that happened, in part, because they paid a billion and a half dollars for Multicare. So -- and today is worth $400 million or some number like that.

Things change massively in this business, and so this technique which is really the best, if one had a good view of the future. We did, and we tried to cope, analytically, and we can go through it in detail, if you want, with those vagaries but within the confines of the analysis. But it's a little dicey.

Q Okay. In your DCF analysis, what was the source for the estimate of future cash flows that you used?

A Yes. For lack of anything better, we used the company's business plan.

Q Okay. But did you believe that the -- that business plan, at least, a reasonable estimate of future profits?

A Well, it's probably most accurate in the early years. You know, it's probably most accurate about tomorrow and less accurate as time goes along. In fact, even in the time since it was created, the estimates for this year have moved around some, and I dare say the estimates for next year will have moved around some, too. That's not taking any particular criticism of the management. This is a very difficult business to forecast because of the variability in revenues.

Q Now, I see that you used five years of projected earnings, is that because the business plan goes out for five years?

A That's correct. We put in here on pages 9 through 11, we laid out the numbers in the companies business plan, first, Genesis alone; second, Multicare, and then third, the combined company.

Q Now, in your DCF analysis, at what rate did you discount back to the present the future cash flow?

A We bracketed the cost of capital between 9 percent and 11 percent. The derivation for that is in here. We gave the Court a page that may be helpful, page 12, on the weighted average cost of capital. A word about what this is. It's easier to say than to know the meaning of. The weighted average cost of capital, it's very important, too, in analyzing this industry, Your Honor. The weighted average cost of capital is the opportunity cost of the capital provided to the enterprise, adjusted for risk.

What that means for debt is relatively simple. It's the rate of interest they pay. It means that a lender would be willing to lend the company at a stated rate of interest instead of lending that same money to somebody else because he feels, on a risk adjusted basis, that it's appropriate. That's a market -- that's what we mean by a market rate of interest.

For the cost of equity, it's more difficult. The cost of equity is the same idea. It is the opportunity cost for an investor investing in this stock rather than some other stock, adjusted for risk. Investors can put their money in all

kinds of things, ranging from government bonds which are the riskless end of the spectrum, all the way to venture capital investments which are, perhaps, the riskiest part of the spectrum, and the cost of equity to this company or to any particular company is supposed to be the opportunity cost of equity capital for that company.

Here, because this company has been in Chapter 11 because the industry has seesawed so much, we've frankly coped out, and we used a normal range of equity returns, 12 percent to 15 percent, which is what produces the range of weighted average cost of capital. I've seen in some of the other reports that you've shown me in the last week, people use cost of equity as high as the 20, 22 percent neighborhood.

I think that's defensible because this is an industry that mostly went bankrupt, and it would not be a craziness to say that investors -- to put equity capital in here would require a surplus rate of return. We didn't do that, it would have driven the values down by a lot more, and I think it's -- I think that's really throwing a dart at the moment to come up with a cost of equity for this company.

Q Okay. In addition to discounting back to the present the future cash flow, what else did you do in performing this analysis?

A Well, there is a business of exit multiples. We haven't had a lot of testimony about that, but it -- we show you

something about this on page 13. If you look, Your Honor, in the middle of the page, we have something called value of free cash flow (present values), and we have bracketed cost of capital, as I said, between 9 and 11 percent, but let's look at the mid point of 10 percent for ease of discussion.

If we went back a few pages, you would see the free cash flow for the company in each of the enumerated plan years. If one discounts only that enumerated stream of cash flows for five years time at 10 percent, it provides a present value answer of $242 million. Well, we're talking about billion dollar valuations. Where does the rest of the value come?

Well, the rest of the value comes because in the year 2006, that's merely the horizon of the company's business plan, it's not the end of the life of the enterprise. It would be assumed that at the end of 2006, we still have a profitable business with a remaining long term future. The long term future needs to be captured in a discounted cash flow. This is not a machine that wears out by 2006 and you throw away.

What's called the terminal value is a shorthand for the remaining future of the business, and if you look in the table above that says terminal values, on the line that says 10 percent, you will see that the answer to the question, what is the remaining future of the business, as we depict it, can be between $500 million and a billion dollars, depending upon what you assume, but in any case, significantly more than the

present value of the enumerated cash flows during the period of the business plan, i.e., be careful about exit multiples because they are the whole game in arriving at the answer. It's so easy to, you know, pick one, but by just picking one, you're really determining the answer to the question.

In the case of our work, we were motivated highly and analytically by the poor return on invested capital in this business, vis-a-vis, the weighted average cost of capital. If we go back to the page of comparables, which is number 7A behind Tab B, I remind you that adjusted for leases, the return on capital for Manor Care, the stellar performer, is only 7 percent. For our debtors, it's 4 percent for the Genesis, the long term care business is 3.9 to be exact, and 3.2 for Multicare.

Well, if the opportunity cost of capital is 10 percent and the company is earning 3, a moment's thought will tell you that company can't attract capital because the capital earns less than it costs. Now, the way that plays out is real life, you can see, vividly, the fortunes of the dot com universe over the last two years. Companies came out with high expectations, high promised eventual profits and they raised money and there were initial public offerings, and we remember reading that stocks doubled and tripled, you know, the first day, and if your broker didn't get into one, he was a bad guy kind of thing, and now they've fallen to earth.

Why? Because they can't finance -- they've run out of money. They can't produce. They haven't yet or didn't promise to produce a return on capital adequate to justify a next round of equity financing. They couldn't finance, so they went broke.

If this industry doesn't get its return on invested capital up to a point where it is profitable for savers to invest their savings in it, it will go broke again. That's why when you factor it against the variability of the government's role in reimbursement, you have to conclude that the future of this industry is ambiguous, at best.

In any event, when we looked at all of that, we concluded to assign an exit multiple. We give you ranges, I mean, it's the -- it's one of the things people like us do, and the range of exit multiples of 6.5 to 8.5 roughly brackets the universe of contemporary valuation multiples. We chose the lowest of the lot, 6.5, to give some analytic weight to the points I just made to you.

If pushed, I would be equally happy to go lower. I mean, we have a chart in here called capitalized notepad. What that means -- that's what you do, analytically, when you see a company whose return on capital is not better than its cost of capital. And what that says is whatever the growth is going forward, it's not valuable to capital owners because it doesn't produce a return above the opportunity cost. So, it treats the

future as a constant, as an annuity, and in just discounts, which would give you for the combined companies a terminal value of $686 million.

We chose to use, instead, a more conventional exit multiple of 6.5, and so we use a terminal value of a billion dollars. That's a few hundred million dollars higher, and so we wind up with a billion and a half dollar enterprise value, and that's because the task before us isn't just to give you our sense of true intrinsic value, it's to give you some kind of an estimate of what the market will price the company at, and so we're stuck with the market prices all of which we feel that are a bit fancy.

Q Just to review with you one more time the capitalized notepad, if you were to use that for determining the terminal value, you would have resulted in a much lower number, is that correct?

A Yes, we would have had an enterprise value for the combined companies of about a billion dollars on this approach, but we thought that from the point of view of anticipating how the market will likely price these securities, the market is more excited about this company than that, and so we chose to ignore that one.

Q Now, you concluded, therefore, in your DCF calculation, the company had a value of approximately what, and where does that appear in your report?

A Well, the DCF calculation that was selected was a billion 463, and if you look back to page 3, we had come up with a range, using comparable company analysis that it was a billion one to a billion four, and we -- I'm sorry, for the total company, it was a billion four to a billion eight. The DCF answer lay within that range, so we made no separate point about it.

Q Now, was there a third valuation method that you employed in your analysis?

A Yes.

Q And would you describe the process you filed in utilizing that method?

A Yes. I noticed that other people didn't do this. This takes the approach to weather forecasting where you look out the window. If the question -- the question that we're asked to answer is, what's the value of the company, meaning what's the fair market value of the company, meaning what's the value at which buyers and sellers would agree to trade securities. It happens that this company has been in Chapter 11 for a year, has had its plan and disclosure statement on file for months, and there has been massive trading in the bank debt and the bonds of the company over this period, and there's a market.

And one can blink the reality of that market and ignore it and go to a blackboard and, you know, debate betas and the like, or one can look out the window. I don't rely on

this exclusively, but we looked out the window, and we've been following the pricing of securities. More or less through the case, there are people who quote -- quote these things all the time. We checked a few of those sources, and the answer comes out on page 17.

What we do on page 17 is for Genesis and Multicare, separately, and then on the next page, together, we have them to take the claims of the company, what the market value of those claims is to the extent that those quoted mark, you know what I mean, in the other secured claims of the company, we simply put in a hundred cents on the dollar because the plan treats them as unimpaired.

But for the impaired classes which are the senior lender claims, the general unsecured claims and the senior subordinates, we take the quoted values and apply those to the size of the claim and come up with a market value column which gives you a billion, 245 million for Genesis, which expressed as a multiple of trailing 12 month EBITDA is 7.9.

And just as a footnote, that's kind of interesting because what we came up with, using comparable companies for Genesis alone, again, as an EBITDA multiple of trailing 12 months, was a range between 5.5 and 8.5. So, here's the market giving a 7.9 that frankly gave us some comfort in the analysis, and for Multicare, the answer comes out as an all end value of 414 million, which as an EBITDA multiple is 8.5. We had come

up with a range for Multicare of 5.5 to 8.5, and once again, these are all -- it's like doing navigation.

You know, you take multiple sightings. There's dead reckoning, there's celestial navigation, there's reading the charts. You know, maybe you have a GPS system if you're lucky. There are multiple ways of figuring out where you are. And we looked at all of them, and I -- we put this in here because I think it's relevant and it gets you to an interesting sort of confirmatory place.

Q The multiple range you found in your own analysis of Genesis that you say was 5.5 to 8.5, was that for Genesis long term care alone --

A I'm sorry, Genesis long term care alone.

Q And the combined, if Genesis in the pharmacy business?

A Long term care alone, I have to get the -- the equivalent, I'm sorry, thank you, the equivalent multiple for all of Genesis which would correspond to the market, I'm reading from page 3, is the reorganization value on an EBITDA basis, I guess, for the whole company is between 6.9 and 8.9.

Q Okay.

A And on page 18, you will see that it comes out at 8.0. Is it conclusive? No. Is it confirmatory? Yes, I think so.

Q In your opinion, is the fact that Genesis and Multicare are currently in Chapter 11 a basis by which to discount this method?

A Well, perhaps a touch. There's a remaining uncertainty as to how this hearing will come out, and will the plan on file be confirmed, so I'd say that there would probably be some moderate depressing effect on that, but these things have been out there and disclosed for a long time.

Q And in fact, the result comes within the range that you found for your comparable company analysis, is that correct?

A That's correct.

Q Now, just summarizing and referring back to Page, I believe it's 3 of your report?

A Yes sir.

Q Could you tell us what your conclusion is as to the most likely valuation of Genesis alone, long term care business and pharmacy, business together?

A Yes. The most likely Genesis combined valuation is $1.3 billion.

Q And what is the most likely valuation that you found or conclusion as to Multicare?

A The most likely valuation would be $343 million.

Q And for the combined Genesis and Multicare?

A $1.6 billion.

Q Now, in addition to valuation, does your report provide any other analyses?

A I'm not sure I understand the question.

Q Specifically, let me refer you to pages 20 to 22 of your

report.

A Oh, yes. Thank you. The -- on pages 20 and 22, this is akin to what Mr. Walsh did yesterday when handing the Court tables of the hurdles, there's a point to this hearing, and the question is, is fair and equitable, and so we took the range of the valuations and applied them to the plan recoveries to give the benefit of a recovery calculation by class of creditor in the plan. On page 20 is the low end of the valuation. For purposes of discussion, perhaps we should read from page 22 which is the high end of the valuation.

Q If -- if you would wait one moment, Mr. Schulte, I'd like to show you a new document. Your Honor, may I approach the witness?

THE COURT: Sure.

(Brief pause)

BY MR. ZELMANOVITZ:

Q Mr. Schulte, I've handed you what has been marked for identification as Mellon Exhibit 2. Can you identify that document for us?

A Yes. This is a revision to the pages 22 through 24 of the -- of the plan that we prepared.

Q You said 22 to 24, is that --

A I'm sorry, 20 through 22. Forgive me.

Q Now, what updated or revised information does Mellon Exhibit 2 include?

A We realized in preparing for this hearing that in the report we had taken into account only of adequate protection payments through the end of June. And here we are at the end of August, and so, we updated this to take into account the adequate protection payments received in July and August. In other respects, it's the same.

Q Now, I believe you testified that you utilized your range of valuations that you had come -- had found in applying this analysis, is that correct?

A That is correct.

Q Okay. Can you tell the Court with respect to each one of the valuations what you have concluded as to the recovery by the senior lenders, and that's total recovery by the senior lenders, from Genesis alone?

A All right. I'm looking at the top part of the first page at the low end valuation, what we deem to be conservative, of a billion, 438 million dollars. If you look at the top section of the page, it says Class G-2, the senior lender claims, and in the far right-hand column, the calculated recovery is 74.8 cents before taking into account post petition interest.

What this does is it, in effect, it deems the adequate protection payments. It's a deemed recharacterization of the adequate protection payments as payment against claim rather than post petition interest. It counts as money received but recharacterizes it, and on that basis, it's

recovery of 74.8 cents.

And similarly, if you go to the most likely case, with the all end valuation is a billion 641 million, that statistic meaning the senior secured lender recovery, leaving aside post petition interest is 87.4 cents. It's on that top part of the second page, Your Honor. There's a column on the right called total, which the dollar recovery is $969 million against a claim of $1,909,000,000. Perhaps, take a second just to walk through the elements of that recovery.

In the first column, just to get you to the total of the 969 million, $130 million of adequate protection payments will have been received through the end of August. The plan gives the senior secured lenders no cash. The plan gives them $94.9 million of new debt, which we assume would be par debt, debt that's worth its full face amount. It gives those same lenders $31 million face amount of preferred stock, which we take, it's a liquidating value of $31 million for this purpose, and it gives the lenders 30,485,000 shares and no warrants in the new merged, pro forma merged entity.

The value of that is driven by the enterprise value that the page is about, namely, the $1,600,000,000 number. If you add the dollar values of those across, there's the full recovery including adequate protection receipts, and for this purpose, there's no computation of post petition interest, $969 million or 87 cents.

Q And even the most optimistic, the high end of the range, what would be the total recovery?

A In the high end valuation, a billion, 844, the high end recovery for Class G2 is $1.1 billion, which is 99.7 percent, again, without post petition interest.

Q So, that's even before any payment of post petition interest, it's only a recovery under 100 percent.

A Yes, and that's at the high end of the valuation. Similarly, while we're on this page, if I could, the Class G5, the senior subordinated claims, the objecting class, on this high end valuation is receiving $56.7 million worth of securities, or a 14.7 cent recovery, notwithstanding the failure of Class G2 to be paid in full with or without post petition interest.

Q Now, turning to a different or a related topic, Mr. Schulte, in performing your evaluation analysis, did you believe that the combined Genesis/Multicare was entitled to an enhanced or increased enterprise valuation because of the post confirmation merger of the two entities?

A No.

Q And can you tell us why not?

A The entities have, for all relevant business purposes, been merged for a few years now. They operate together. Any benefits of marketing, purchasing have been realized. The professional expense might go down some if they could stop